

Docket WS-01303A-20-0298
Epcor Acquisition of Johnson Utilities Assets
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Exceptions to Recommended Opinion and Order and Comments

Notice was Inadequate

The public noticing for the application did not provide sufficient information for customers to know they should be concerned. They were informed instead that rates would not be affected. The application itself states “current Johnson customers will incur no adverse impacts from the transaction.”

The rate impacts were disguised. Customers were misled. Once social media started talking about customers having to pay for the purchase price, the Commission started receiving negative comments. A few hundred people probably noticed the social media discussion. While the current request (\$69 Million from customers over 15 years) is significantly less than the original “Acquisition Premium” request (\$160+ Million over 25 years), customers should have been notified directly what the plan is to comply with A.R.S. 40 – 367(A). The Arizona Administrative Code was not complied with either even though a sufficiency letter was issued.

The issued notice went to some effort to move customers off the scent of what was being requested; rather than simply explaining what the application did do, it explained what it would not do: “Nothing will affect rates” was the message.

While the notice did mention the “acquisition premium”, little thought was given to it by customers since they knew whatever that is it would not impact their family budget. Even the professionals in this proceeding did not know what they were talking about when discussing the acquisition premium. How in the world were customers supposed to figure it out?

In the notice provided with the application – Exhibit 1, Epcor told customers it was asking for “an acquisition premium of \$63 Million, reflective of the necessary investment to reconstruct the Johnson Utilities systems.” Customers may have thought “OK, they have to get the money from somewhere and my money will go to good use fixing things.” They had no idea Epcor wanted the \$63 Million (It would have been over \$160 Million over 25 years) for its pocketbook and was going to come after them again for more money to fix the system.

The last notice we received was with the November bills before the hearing began. See my comments of December 2. This was another notice to quell concerns of adverse impacts. Many customer comments expressed surprise that their water bill could be affected.

If this type of deception is the way Epcor treats its customers during the courtship, what will it do to us after the wedding?

The Commission should determine notice was inadequate.

The Deferred Debit Would Not be Fair

Epcor states it is purchasing the assets of Johnson Utilities at a price it considers to be fair market value. It pays X dollars (the actual price is not publicly available), and receive assets with a value to Epcor equal to X. Epcor is whole. In addition, Epcor wants to collect \$69 Million from myself and other customers for which it will not provide any goods or services. Epcor get to retain the assets it values at the purchase price plus it wants to retain the \$69 Million it wants the Commission to force customers to pay over and above cost of service. This is not fair.

Metrics to Approve Deferred Debit

If the Commission chooses to approve the Deferred Debit, it needs to detail the criteria its policy uses to approve Deferred Debts like this one, especially if Decision 75626 does not necessarily apply. Thus far, all the record reflects are bald assertions that the transaction is not viable absent some forced contribution from customers. There is no empirical data. There are no cash flows. There is a lot of financial gymnastics in valuation but there are no projected financial statements or demonstrable harm absent the debit.

If the Commission approves the Deferred Debit, it needs to find justification for both the amount and the 6% interest rate. Thus far the only justification for \$45 Million seems to be its less than half the (undisclosed to the public) purchase price which, as discussed below, is excessive.

In May 2020 Epcor issued a \$300 Million unsecured 30 year note at an effective interest rate of 2.95%. Thus far I have seen no support for the 6% interest rate. What we do know is the revenue stream is good as gold. The way Epcor and Staff set up the surcharge, Epcor can lose 30% of its customer base and still collect the same amount of revenue. The risk characteristics of the debit are more akin to Treasury securities than anything with risk justifying a rather healthy 6%.

Until there is a rate case where rigorous financial metrics are scrutinized, the appropriate size of the debit (if any) cannot be determined. Until the underlying financial risk of the debit is established (probably near zero), the Commission cannot determine that 6% is correct.

Ability to Recover a Portion of the Purchase Price through rates

There has been a lot of discussion about rate base, the mechanism utilities use to recover investments and associated financing costs.

Fact: Epcor has made \$46 Million in Capital Improvements since becoming the Interim Manager (December 8 Open Meeting). This was funded by Cash on Hand (\$26 Million) and Operating Revenue (\$20 Million). Epcor testified that \$14 Million of this was moved to Plant in Service by August 2020 and would likely be included in rate base during the next rate case (video record Nov. 19 @ 2:05).

That should result in a \$14 Million reduction to the \$45 Million debit requested. See my comments of December 9. To the extent the other \$32 Million finds its way to rate recovery, the

Deferred Debit should be reduced. Any addition to rate recovery not associated with a post-acquisition Epcor expenditure is by definition a recovery of the purchase price and should serve to reduce the deferred debit.

The ROO addresses the accounting change that can add over \$48 Million to rate recovery if it is sustainable. The record also reflects a potential \$79 Million addition to rate base associated with a Reconstruction Cost New Less Depreciation calculation (Exhibit SP-1). Epcor testified (video record Nov. 19, 2:20) that the \$79 Million will not be included in rate base at this time because it would be “far too much of a burden for customers to bear”. So rate base is too low or negligible which requires me to subsidize the purchase, but allowing rate base to become not negligible results in rate base being too high for customers. It appears that rate base is negligible by design and desire.

These are amounts that require no expenditure on Epcor’s part but might be included for recovery in rates. According to Epcor, the amounts are certain enough to support the need for a \$45 Million contribution to the purchase price from customers like me but not certain enough to anticipate including in rates for cost recovery during the normal ratemaking process.

If the Commission approves the Deferred Debit, it should make clear that the \$45 Million amount should be reduced if any of these \$173 Million potential additions to rate base make their way to recovery in rates. Or if any other items are included in rates for recovery that are not related to Epcor post-acquisition expenditures.

The Purchase Price Is Not Reasonable

Decision 75626 requires that the purchase price be reasonable before customers are asked to contribute to the price or to the cost of improvements not otherwise recoverable. It also wisely limits the contribution to 20% of original cost rate base.

The size of the purchase price drives Epcor’s request for my contribution. “If there were not such a large outlay by Epcor initially to acquire the system, then this would be normal utility business.” (Nov 19 video record at 1:32). Were the purchase price reduced by \$45 Million Epcor would have no need for my subsidy. But the price might still be extremely generous to the seller.

In determining the reasonableness of the purchase price, the Commission needs to look to the record. Exhibit 2 to the application demonstrates valuation metrics used to give credence to an acceptable purchase price for a utility system. It was also used to develop the amount of the Deferred Debit. System values in Exhibit 2 range from \$890 per connection to \$8,464 per connection. They are all based on Rate Base for that particular system because rate base is what gives economic value to a utility system. Each utility has unique histories and circumstances that contribute to its individual rate base and, therefore, revenue potential and market value.

In assessing the validity of the purchase price, the Commission should look similarly to rate base as an indicator of market value. The rate base for Johnson Utilities is somewhere around \$140 per connection assuming Epcor’s proposed \$9.7 Million rate base in the current rate case is correct.

There is testimony that the purchase price is over \$95 Million. What the Commission needs to determine is whether it is reasonable for the assets of Johnson Utilities to be priced 1,000% higher than the other systems on Exhibit 2 relative to the \$140/connection economic value. Should customers be required to pay 450% of economic value to acquire the system? If so, why? I see no evidence in the record that the assets of Johnson Utilities should command such a market premium.

Epcor and Johnson Utilities are monopolists. Monopolists extract value out of the market by using market power to extract value that exceeds economic cost of service. The Commission exists to prevent that from happening. In this proceeding, the Applicants ask the Commission to look to benefits and value instead of cost. That is what monopolists do.

I value my utility service much higher than my utility bill costs. That is what makes the imposition of a surcharge feasible. The difference between cost and value accrues to me as Consumer Surplus. Any introductory microeconomics book describes the evils of monopolies in exploiting market power to raise prices above cost to garner for themselves Consumer Surplus. In this case, the Applicants ask the Commission to export \$69 Million from my community that could otherwise be used in the local economy providing jobs, goods and services.

I am entitled to that surplus value. By trying to get Commissioners to focus on value instead of cost, Applicants are asking the Commission to join the monopolists in extracting from me value for themselves that I am entitled to. I should not have to pay more than cost of service.

The purchase price is unreasonably high. The owner of Johnson Utilities has already drained most of the value from the utility. The Commission should reject the Deferred Debit as there is plenty of headroom to accommodate a reasonable price without it.

No Arms Length Transaction

The Commission should decide that the transaction was not done on an arms-length basis for the reasons discussed in my November 24 response to Commissioner questions. Negotiations were between two Monopolists seeking to extract as much value as possible from the market, cognizant of the potential for having a third party – me – contribute to the deal. My contribution to the value of the deal was sufficient to overcome any enmity between the Monopolists.

No independent business appraisals were provided. If I get a house loan I need an appraisal to borrow \$200,000. A \$100 Million deal asking me to contribute my share of \$45 Million for which I receive nothing deserves an independent appraisal if not two. There is no independent confirmation of the market value of the assets.

Funding for Infrastructure Improvements Is Available

Please see my December 9 comments. Suffice it here to say that funding mechanisms and tools are available to provide capital funding should Epcor wish to use them.

The developers are rightfully incensed that projects are held up by a lack of utility infrastructure. I hope they succeed immeasurably. I would like to have a house in San Tan Valley some day with a pool and four car garage. The more success they have the better my opportunities.

The developers should direct their angst to Epcor, not Johnson or the Commission. Given the Doomsday scenario described by Epcor at the December 8 Open Meeting, why has it not applied for a "System Improvement Fund" surcharge that generates dedicated, segregated revenue from customers to backstop financing for capital improvements?

Epcor states that the proposed 15-year \$69 Million surcharge provides a revenue stream adequate to secure \$45-\$55 Million in funding for investment. Instead of using these dollars to pay Johnson significantly more than the value of the revenue potential of the assets themselves, they can be used for infrastructure improvements. This would be consistent with the Notice contained in the application that told customers the money would be used to improve the system as well as Decision 75626.

At the December 8 Open Meeting Johnson's counsel indicated that they have been so busy working on this transaction that they have not had time to consider acquiring financing for infrastructure. The application was filed on October 5, 2020. Assuming it took 90 days to negotiate, the lack of funding today may be a result of attention to the sale application instead of desperate customer needs since late June.

Decision 75626 authorizes system improvement fund surcharges. What is taking Epcor so long? Why is Epcor placing the economic and physical health of my community at risk instead of using the tools available to ensure the system is adequate? To put pressure on the Commission to abandon its regulatory integrity?

The Commission should not succumb to this manufactured crisis, to the Hobson's choice the Monopolists present: Bend to our will or we will destroy your economy and threaten the health and safety of the community.

The reason we are in the position we are is because of the Commission's timid regulatory response to problems at Johnson Utilities over the years leading up to the appointment of the Interim Manager. Please do not fail us again.

The Commission could even approve the Plan of Administration for the Deferred Debit in this proceeding, direct that the funds be used to execute the Capital Improvement Plan, and order Epcor to report back in 30 days about whether it can obtain the first leg of financing for 2021 investments to the extent operating revenue is insufficient.

Costs of the Proceeding

The Commission should ensure that no costs associated with this docket are funded from Johnson Utilities customer proceeds.

Thank you.

Steve Pratt